

## Case 13-10A

### LOL — Income Taxes

LOL (the “Company”), an SEC registrant with a calendar year-end, is a manufacturer and distributor of sports equipment. The Company was created in 1989 and is headquartered in Southern California. The Company has manufacturing operations and numerous sales and administrative locations in the United States. LOL files a consolidated U.S. federal tax return. (This case will not consider the evaluation of the state jurisdictions; it will only consider the federal jurisdiction.)

#### Part 1 — Taxable Income

As LOL’s auditor, you are now performing the Company’s year-end audit for the fiscal year ended December 31, 2018, and have the following information available to you:

- The Tax Cuts and Jobs Act (the “Act”) was enacted in the United States on December 22, 2017, and was accounted for accordingly by LOL.
- The Act changed the rules related to tax loss carryforwards such that tax loss carryforwards arising in years after 2017 have an unlimited carryforward period though they may only be used to offset 80 percent of taxable income in a given year. Further, the Act removed the carryback period that had previously been allowed.
- LOL’s draft income statement and excerpt from tax footnote as of December 31, 2018 (Handout 1).
- The tax loss carryforwards detailed on Handout 1 that arose before 2018.
- A deferred tax asset realization analysis showing pretax book income projections (Handout 2).
- The projected income schedule (realization analysis above) projects organic growth beginning in 2020 after stemming the decrease in pretax book income.
- The nondeductible goodwill impairment charge is a permanent item.
- LOL does not have the ability to carry back any losses to prior periods.
- A significant customer declared bankruptcy in 2018; therefore, the Company wrote off all accounts receivable from this customer. The Company is considering the exclusion of such expense when evaluating whether future income is objectively verifiable.
- The Company does not have a history of operating losses or tax credit carryforwards expiring unused.
- The Company has identified the following possible tax-planning strategies:

- Selling and leasing back manufacturing equipment that would result in a taxable gain of \$20 million.
- Selling the primary manufacturing facility at a gain to offset existing capital loss carryforwards.

**Part 1 — Required:**

1. What are the four possible sources of taxable income according to ASC 740?
2. How much of the reversing taxable temporary differences may be considered in estimating future taxable income?
- 3a. In evaluating the income that LOL is projecting related to future operations, is LOL in a cumulative loss position (assuming LOL considers three years as the period over which to evaluate pretax accounting income or loss from continuing operations for cumulative losses)?
- 3b. In evaluating the income that LOL is projecting related to future operations, may LOL exclude the impact of the impairment of the nondeductible goodwill when estimating future taxable income?
- 3c. In evaluating the income that LOL is projecting related to future operations, may LOL exclude the expense from writing off the accounts receivable from the customer who declared bankruptcy when evaluating the projections of future income?
- 3d. In evaluating the income that LOL is projecting related to future operations, the Company has projected growth in its future projections. Does the evidence of historic losses affect our ability to accept the Company's estimate of future growth?
- 3e. In evaluating the income that LOL is projecting related to future operations, in an effort to satisfy your appropriate professional skepticism, what evidence might you ask for to support the Company's projections?
4. Would the tax-planning strategy to sell and lease back manufacturing equipment be a tax-planning strategy that is considered prudent and feasible? Why or why not?
5. Would the tax-planning strategy to sell but not lease back the primary manufacturing facility be a tax-planning strategy that is prudent and feasible? Why or why not?

**Part 2 — Intraproduct Allocation Consideration****Additional Facts**

Assume that a valuation allowance of \$100 million is recorded as of December 31, 2018 (\$150 million deferred tax asset (DTA) less \$50 million reversing deferred tax liabilities (DTLs)).

Further assume that during 2018, the Company recognized a loss of \$50 million in accumulated other comprehensive income (AOCI) related to a pension adjustment from a loss in investment value.

The Company's effective tax rate, without the recognition of a valuation allowance, is 21 percent.

**Part 2 — Required:**

6. Calculate the tax effect on the loss of \$50 million recognized in AOCI in 2018.

**Additional Facts**

Assume that a valuation allowance of \$100 million is recorded as of December 31, 2018 (\$150 million DTA less \$50 million reversing DTLs).

Further assume that the Company's projection for 2019 pretax book income of \$0 is accurate, but the Company sells a component of the business and recognizes the component as a discontinued operation.

The discontinued operations earn \$20 million before tax, and the continuing operations lose \$20 million before tax for a net pretax book income of \$0.

As described above, the Company has a full valuation allowance.

**Part 2 — Required:**

- 7a. Is there a tax benefit on the loss of \$20 million from continuing operations?
- 7b. Is there a tax provision on the \$20 million of income from discontinued operations?

**Part 3 — Interim Reporting****Additional Facts**

Assume that a valuation allowance of \$100 million is recorded as of December 31, 2018 (\$150 million DTA less \$50 million reversing DTLs).

Further assume that the actual 2019 net income before tax was \$0 as projected at the end of 2018 and that the \$100 million valuation allowance is still needed as of December 31, 2018 (i.e., the future forecast of income is not considered objective and verifiable). In calculating the 2020 annual effective tax rate (AETR) at the beginning of the year, the

Company projected income before taxes of \$40 million (\$10 million per quarter). With the effective tax rate of 21 percent, the \$40 million of income would result in a tax provision of \$8.4 million during 2020 (\$2.1 million per quarter) before consideration of the release of the valuation allowance.

Assume, however, that the net operating loss carryforwards will be used as income is generated during the year, resulting in annual estimated tax of \$0 and an annual estimated effective tax rate of 0 percent. In the absence of a release of the valuation allowance during 2020 from a change in estimate, and provided there are no other changes in deferred taxes, the year-end valuation allowance would be \$91.6 million (\$100 million less \$8.4 million) as a result of the income earned in 2020.

In the second quarter of 2020, LOL determined that there was sufficient evidence of future taxable income to conclude that the DTA was more likely than not to be realized.

**Part 3 — Required:**

8. Calculate the tax provision (benefit) that would be recognized in the second quarter of 2020.